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Briefing Report to the Chairman, Subcommittee on Antitrust, Monopolies and Business Rights, Committee on the Judiciary, U.S. Senate

March 1992

INSURER FAILURES

Differences in Property/Casualty Guaranty Fund Protection and Funding Limitations

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March 12, 1992

The Honorable Howard M. Metzenbaum
Chairman, Subcommittee on Antitrust,
  Monopolies and Business Rights
Committee on the Judiciary
United States Senate

Dear Mr. Chairman:

This briefing report responds to your June 17, 1991, request for information on state property/casualty guaranty funds. The increased magnitude and frequency of insurance company insolvencies during the 1980s has heightened concern over the amount and extent of protection these funds offer policyholders and claimants of insolvent companies. Our review focused on differences in guaranty fund protection among the states as well as current or potential problems the funds may encounter in paying the claims of insolvent companies. This review focused primarily on the statutory framework which defines the structure of the guaranty fund system rather than concentrating on the daily operations and procedures of individual funds. We briefed your staff on the results of our work on March 5, 1992.

BACKGROUND

Property/casualty guaranty funds exist in all states to protect policyholders and claimants from financial loss due to an insurance company insolvency. Most states created these funds in the early 1970s in response to a wave of insolvencies in the automobile insurance market and to avoid a federally mandated system. Almost all of the funds are nonprofit associations established by state law and operated by the insurance industry, excluding three, that are operated by state insurance regulators.

All guaranty funds, except New York's, are similar to the 1969 model law developed by the National Association of Insurance Commissioners (NAIC). Among other things, this model law specifies the types of claims that should be covered and the maximum amount of coverage for each type. It covers all types of property/casualty insurance except for such things as ocean marine and financial guaranty insurance. The NAIC model act provides for (1) a $300,000 limit on claims, other than workers' compensation; (2) unlimited coverage on workers' compensation claims; and (3)

coverage of noneconomic losses associated with pain and suffering, regardless of claim type.[1] All funds, other than New York's, belong to the National Conference of Insurance Guaranty Funds (NCIGF). Among other things, this organization assists in coordinating activities in multistate insolvencies and serves as an information clearinghouse.

The funds are financed by assessing insurance companies a small percentage (usually capped at 1 or 2 percent) of their in-state premium income. Because of this assessment structure, there are limits on the amount of claims the funds can pay annually. With the exception of New York, assessments are not made until after an insolvency occurs.

RESULTS IN BRIEF

Policyholders and claimants with unpaid claims resulting from an insurance insolvency can only collect from the state where they meet the residency and other claim requirements contained in that state's guaranty fund statute. Though state guaranty funds generally follow the NAIC model, there are still wide variations in coverage. For this reason, policyholders and claimants across the country receive substantially different amounts of protection, and may receive less protection than the claim limit coverages included in the NAIC model law. We reviewed the coverage provided by the funds and found that:

-- 29 funds met all claim limit coverages,

-- 4 funds set higher claim limits than the $300,000 NAIC limit, and

-- 18 funds had lower limits than 1 or more of the NAIC claim limits.

The state-by-state variations in claim limits have raised questions of fairness to policyholders and claimants. Because of these differences, for example, two individuals suffering similar losses and having similar insurance with

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[1]The model act does not address noneconomic losses. However, according to the head of the NCIGF, such losses may be covered because the act does not specifically exclude them. States which do not cover these losses specifically cite them as an exclusion in their guaranty fund statutes.

the same failed insurer can receive substantially different claim payments depending on their states of residence.

Although assessment levels on surviving insurers have usually been adequate to pay claims, the increasing size of insolvencies over the past 7 years has raised questions about fund capacity. Two fund managers, for example, expressed concern about the continued ability of their funds to pay all claims at current assessment levels should additional insolvencies occur in the near future. They said that, in recent years, claims on their funds exceeded their assessment capacity. In addition, at least six other funds hit or nearly approached their assessment caps in specific years and needed to obtain additional financing to meet their claim obligations.

A simulation model we developed showed that the assessments of about three-fourths of the funds would be inadequate to cover claims from a hypothetical company failure with first year claims of about $4 billion. This amount is approximately equal to the average amount of claims paid in 1 year by 1 of the 10 largest U.S. property/casualty companies.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to determine the extent to which guaranty fund protection is consistent among states and the current and potential problems the funds may encounter in paying claims of insolvent companies.

To address these objectives, we reviewed guaranty fund statutes; updated legal research; and discussed current guaranty fund issues with various fund officials, insurance regulators, industry experts, and consumer groups. We also developed a model of a hypothetical failure to assess the ability of the guaranty funds to handle one large insolvency.

We did our work from December 1990 to October 1991 in accordance with generally accepted government auditing standards.

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The findings in this report were discussed with officers of NCIGF. They provided comments and suggestions for clarifications. We incorporated these suggestions where appropriate.

As agreed with the Committee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time we will make copies available upon request. The major contributors to this report are listed in appendix III. If you or your staff have any questions concerning the report, please call me at (202) 275-8678.

Sincerely yours,

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

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ABBREVIATIONS

NAIC	National Association of Insurance Commissioners
NCIGF	National Conference of Insurance Guaranty Funds

Objectives

To determine:

- the consistency of guaranty fund protection across states
- the adequacy of assessment levels to pay existing claims
- the future ability of funds to pay claims resulting from a large failure

OBJECTIVES

We reviewed differences in the state property/casualty guaranty fund system and the current or future problems the funds may encounter in paying the claims of insolvent companies. Specifically, we determined the extent to which guaranty fund protection varies among the states and identified current and potential problems associated with the financial capacity of the funds to pay claims when due.

Methodology

- Conducted legal research
- Identified funds with inadequate assessments
- Developed a simulation model to measure financial capacity
- Conducted interviews

METHODOLOGY

To accomplish our objectives, we did the following:

-- We reviewed guaranty fund statutes as of June 1990 to update previous research conducted by the NCIGF on guaranty fund statutes. This review focused on the type and amount of fund protection and the assessment process.

-- We discussed the financial capacity of the funds with managers of seven state funds and the NCIGF where the annual assessment process was inadequate to cover all claims due in a single year. The interviews focused on (1) the financial capacity of these funds; (2) the steps taken to ensure that claims were paid and (3) whether these funds may have problems covering additional insolvencies in the future.

-- We developed a simulated large insurance company failure to determine whether or under what circumstances the annual assessments of guaranty funds would be inadequate to meet claims due in a single year.

-- We interviewed various fund officials, insurance regulators, industry experts and consumer groups with experience in insolvency proceedings.

-- We discussed our findings with officers of the NCIGF.

-- We did our work from December 1990 to October 1991 in accordance with generally accepted government auditing standards.

Guaranty Fund Payment Limits Recommended by NAIC

NAIC claim limits:

- $300,000 claim limit for claims other than workers' compensation
- Unlimited workers' compensation coverage
- Coverage of noneconomic losses

GUARANTY FUND PAYMENT LIMITS RECOMMENDED BY NAIC

The fact that there are differences in guaranty fund coverage is frequently mentioned as a concern by a number of guaranty fund experts, Members of Congress, and fund officials. They believe that these differences are inequitable.

Policyholders and claimants with unpaid claims resulting from an insurance insolvency can only collect from the state where they meet the residency and other claim requirements contained in that state's guaranty fund statute. Because states have varying levels of coverage, policyholders and claimants across the country receive substantially different amounts of protection and may receive less protection than the claim limits contained in the NAIC model law. These limits include (1) a $300,000 limit on claims other than workers' compensation; (2) unlimited coverage on workers' compensation claims or some other state protection unrelated to the guaranty funds; and (3) coverage of noneconomic losses associated with pain and suffering, regardless of claim type.[1]

[1]The model act does not address noneconomic losses. However, according to the head of the NCIGF, such losses may be covered because the act does not specifically exclude them. States which do not cover these losses specifically cite them as an exclusion in their guaranty fund statutes.

Guaranty Fund Protection Varies Across States

Funds meeting the NAIC limits

- 29 met all 3 claim limits
- 4 exceeded the $300,000 limit
- 18 were below the limits
  - 1 was below all limits
  - 1 was below the $300,000 and noneconomic loss limit
  - 16 were below 1 limit

GUARANTY FUND PROTECTION VARIES ACROSS STATES

Twenty-nine states met all three of these claim limits and an additional 4 exceeded the $300,000 limit. Their maximum claim payments ranged from $500,000 to about $4 million.

Eighteen states were below the NAIC limits in 1 or more areas. Two of these states were below in several areas. Indiana, for example, was below in all three areas. The state capped all claims, including workers' compensation, at $100,000 and did not cover noneconomic losses. Tennessee was below in two areas. It limited all claims, except workers' compensation, to $100,000 and did not cover noneconomic losses. The remaining 16 states were below in 1 area: 10 limited claim payments to between $100,000 and $150,000, 4 limited workers' compensation payments to $300,000 per claim, and 2 did not cover noneconomic losses.

Several fund officials and experts see the current system as unfair because two individuals suffering similar losses and having similar insurance coverage from the same failed company may receive significantly different claim payments solely because of differences in state coverage. The question of fairness has been raised, for example, by fund experts and the NAIC. Also, NCIGF has questioned the lack of uniformity among the funds. One area cited by one fund manager as inequitable and by the head of NCIGF as causing significant disparities is the inclusion or exclusion of noneconomic losses in claim payments. A claimant whose claim includes these losses, for example, could receive a total payment that is four to five times greater in one state than a similar claimant whose fund excludes these losses.

Assessments Inadequate to Pay for Existing Failures

Assessments alone have not always been adequate to pay for failures.

Eight funds needed to obtain additional resources to meet obligations.

Two funds actually ran out of money.

ASSESSMENTS INADEQUATE TO PAY FOR EXISTING FAILURES

Most guaranty funds are financed by assessing insurance companies up to 1 to 2 percent of their in-state insurance revenue each year after an insolvency occurs. In most states, assessments are not made on all remaining property/casualty companies, rather they are made only on insurers that write the same type of insurance as the insolvent company. For example, automobile insurance claims of a failed insurer would be paid from assessments made on only those companies writing automobile insurance in the state. Funds which assess companies based on the type of insurance business written, maintain separate accounts for these assessments. Companies, in turn, generally pass these costs on to the public or policyholders through state tax offsets, rate increases, or premium surcharges.

Although assessments have usually been adequate to pay claims when due, various fund officials and experts are concerned that the funds may not have the assessment capacity to handle an increase in the size and number of failures.

At least eight funds hit or nearly approached the maximum they could assess insurance companies in a given year in one or more accounts since year-end 1985. These funds got additional money by obtaining legislative authority to increase the amount of money that could be assessed, or to use money from other claim accounts. In some cases, the guaranty funds also borrowed funds.

Five of these funds experienced an actual or potential shortfall at least in part because of the Mission Insurance Company or American Mutual Insurance Company failures, or both. The total projected insolvency costs as of 1989 for these failures are approximately $638 million and $307 million, respectively. The remaining three states experienced problems due to regional failures.

These eight funds did not seek additional resources until they reached or were approaching the maximum they could assess in a given year. Additional resources were obtained by doubling the maximum rate insurance companies could be assessed, assessing insurance companies in one line to pay for insolvencies in other lines, combining separate pools of money within a fund and borrowing money from outside sources. The first three measures required state legislative action and some were temporary, being in effect for up to 5 years. The last was permitted under the existing guaranty fund statutes of the states involved.

Two states, Louisiana and Rhode Island, may need to consider additional actions if previous steps prove insufficient to maintain an adequate level of fund liquidity. According to the Louisiana fund manager, if more companies licensed to sell insurance in

Louisiana fail in the next several years, he will need to borrow additional money or stagger claim payments. Similarly, the Rhode Island fund manager stated that if an additional large insolvency occurs in the workers' compensation line, steps may need to be taken to increase the fund's capacity.

These funds generally experienced difficulty handling insolvencies because the premium base of surviving companies in their states, which is the basis of assessments, is small compared to the cost of particular insolvencies. In Louisiana's case, for example, the Champion insolvency costs are estimated at 5 percent of a particular category of income generated by operating companies, and the fund can assess only 2 percent of this income per year.

The vulnerability of funds in states with a small base of companies relative to the size of insolvencies is a concern to several of those fund managers and NCIGF. The amount of assessments collected in these states is further reduced, they claim, because the funds can assess only those insurance companies that write the same type of insurance that the failed company wrote.

Guaranty Fund Capacity is Limited

Total capacity of all funds would only pay about three-fourths of claims paid each year by one of the largest property/casualty insurers.

Capacity of 33 to 38 state funds would be inadequate to pay their share of the losses incurred in 1 year by 1 of these insurers.

GUARANTY FUND CAPACITY IS LIMITED

Because the assessment process limits the amount of money available to guaranty funds to pay claims in a given year, a number of fund experts are concerned that the system could be overwhelmed by one or more massive failures or a larger number of smaller failures. Although we are not predicting whether this will occur, we do believe that it is important to identify the point at which the financial capacity of the current assessment-based system would be exhausted.

To illustrate the limited capacity of the guaranty funds, we constructed a hypothetical insurance company based on the actual size and distribution of losses faced by large operating insurance companies. Losses incurred by 10 of the largest U.S. property/casualty insurers were averaged to create a hypothetical insurer with a reasonable distribution of losses by line and by state. This insurer was then assumed to fail, and the ability of the guaranty funds to pay its claims was examined. Several simplifying assumptions were made to simulate the effects of a large insurer failure; the circumstances of an actual failure would undoubtedly differ from our model. However, the model illustrates quite clearly the limited resources available to the guaranty funds as they are currently structured. A complete description of this model and of the assumptions used to simulate the effects of a large insurer failure are in appendix II.

The results of our simulation indicated that each of a number of large property/casualty insurers have annual incurred losses of approximately $4 billion. Our results indicated that the total annual assessment capacity of the states' guaranty funds is equal to only about three-fourths of this amount. That is, if the guaranty funds became liable to pay claims equal to the losses paid every year by a single one of the largest insurers, most of the states' funds would be unable to do so with 1 year's assessments. In fact, our results indicate that the total annual capacity of between 33 and 38 state funds would be inadequate to pay their share of the losses incurred in 1 year by 1 of these insurers.

CAPACITY OF THE PROPERTY/CASUALTY GUARANTY FUNDS--A SIMULATION MODEL

Some insurance industry experts have questioned whether property/casualty guaranty funds are capable of bearing the burden of a continuing trend of increased property/casualty failures. To try to answer this question, we devised a simple model to approximate the effect on state guaranty funds of the failure of a hypothetical insurer of a size comparable to one of the largest property/casualty insurers. This is not to say that we anticipate that one of these insurers will actually fail; rather, we wanted to see how the guaranty funds would perform under a large but not unrealistic demand. In fact, such a demand could derive from the combined failures of several smaller insurers. We realize that if such a large demand came about, political realities might force a change in the system. That possibility, however, lies outside the scope of this analysis, which concerns itself with the impact on the present system.

The current system of state property/casualty insurance guaranty funds came into being in the early 1970s, under congressional pressure to provide some protection for policyholders when insurers become insolvent. Since then, the number and size of property/casualty insurer failures have greatly increased. Thus far, state guaranty funds have assessed insurance companies $193.3 million for 67 failures from 1969 through 1980, and more than $3.1 billion for 120 failures from 1981 through 1990.[1]

MODEL OF GUARANTY FUND OBLIGATIONS

In trying to evaluate the capacity of state guaranty funds to handle claims arising from the failure of a property casualty insurer, we had to estimate the potential claim payment obligations of a large insurer and the capacity of the guaranty funds to pay policyholder claims, given the limits on assessments. To carry out this simulation, we had to make a number of assumptions, such as how to measure fund exposure and the distribution of claim payments. While we believe the assumptions we have made are as realistic as possible given the limited information available to us, some are more realistic than others.

[1]Information obtained from the NCIGF.

Potential Losses

The obligations of guaranty funds for a property/casualty insurer failure consist of claim payments for insured policyholders, which are called losses in insurance accounting. The claims for payment of these losses are submitted to the insurer, or--in the case of a failed insurer--to the guaranty fund. Our model does not try to estimate the total value of the claims that would be submitted to the guaranty funds for a particular failed insurer over time, but only the claims to be payable in the first year after failure. Additional claims would likely be filed in subsequent years.

The yearly losses incurred by an insurer include not only losses paid out by the insurer but also unpaid losses and the estimate of losses incurred but not yet reported. We obtained incurred loss data from the NAIC database of insurer-reported financial statement data. In 1989, reported losses incurred by property/casualty insurers were 9.2 percent greater than losses actually paid. Using incurred losses rather than losses paid may overstate the first-year demands on the guaranty funds, but the failure of an insurer, with the resulting publicity, may also accelerate the filing of claims.

The amount of an insurer's incurred losses may also overstate the costs to the funds for several other reasons. Guaranty funds may not cover all losses due to state caps on the amount of claim payments or the possibility that some policyholders may have additional coverage from other carriers. Also, to the extent that the assets of the failed company could be used to cover some claims, the draw on the guaranty funds would be reduced. However, there may be little chance of such recovery in the first years of a liquidation. For simplicity, our model initially assumes that no assets from the failed insurer would be available to guaranty funds in the first year after failure.

To create a hypothetical insurer with a reasonable distribution of incurred losses, we took loss data from 10 of the 12 largest property/casualty insurance companies. We excluded State Farm Mutual Auto Insurance and State Farm Fire and Casualty because the State Farm Group is much larger than any other insurer and thus would distort the averages if included. Of the 10 sample companies we selected, 3 are primarily auto insurers, 3 are primarily workers' compensation and commercial insurers, and the other 4 write a mixed book of both personal lines (such as homeowners and auto) and commercial lines.

From data on incurred losses for these 10 companies, we calculated average losses by line and by state for the 3-year

period from 1986 through 1988. Two hypothetical companies were created by dividing the 10 real companies into 2 groups of 5 on the basis of the alphabetical listing of their names. The third was a composite, or average, of all 10 real companies. The national 1-year loss figures (based on the 3-year averages) for the three composite companies are

-- Company A (average of first 5 companies)	$4,212,488,002
-- Company B (average of second 5 companies)	3,864,414,671
-- Company AB (average of all 10 companies)	4,038,451,337

We believe these estimates to be a reasonably conservative measure of potential guaranty fund exposure. Averaging the loss experience of a number of presumably healthy companies probably understates the losses that would face a large property/casualty insurer that was failing. This would certainly be true if the failure resulted from poor underwriting or from exposure to a catastrophic loss.

Estimated Guaranty Fund Capacity

State funds assess insurers licensed in the state on the basis of their net premiums written. We could not obtain such figures from published sources on a state-by-state basis. The available figures corresponding most closely are direct premiums written in each state. In 1989, direct premiums written by property/casualty insurers were 5.6 percent greater than net premiums written. As a result, our use of direct premiums written may overstate guaranty fund capacity.

For purposes of the model, we assumed that all funds operate on a post-assessment basis, covering the lines of insurance listed. In some states, guaranty fund assessments are divided into more than one account. In those states, assessments for covered losses are levied only against companies writing the same kind of business. Because these constraints vary substantially by state, we assumed that there was only one account for all covered lines in each state. This assumption could have the effect of overstating the actual capacity to pay covered claims in some states because all insurers would be responsible for assessments on all lines of insurance.

We used direct premiums written in 1989 as a basis for calculating guaranty fund capacity.[2] The capacity in each state

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[2]We obtained state-by-state direct premiums written for 1989 from the 1991 Property/Casualty Insurance Factbook, published annually by the Insurance Information Institute.

was estimated by applying the percentage cap in each state to the total amount of direct premiums written in the state.[3] Table 2.1 shows the amount of direct premiums written nationwide for the lines of insurance covered by all state guaranty funds[4] and the maximum guaranty fund assessment based on those amounts.[5]

Table 2.1: Guaranty Fund Capacity by Line of Insurance, 1989
(Dollars in Millions)

Line of insurance	Direct premiums written	Capacity
Fire	$ 3,428.9	$ 55.6
Allied lines	3,051.8	49.4
Homeowners	18,067.7	292.7
Farmowners	1,009.1	16.3
Commercial multi-peril	18,863.8	305.6
Inland marine	5,199.2	84.2
Medical malpractice	5,142.1	83.3
Earthquake	442.8	7.2
Workers' compensation	31,853.1	516.0
Other liability	22,395.8	362.8
Auto	94,431.8	1,529.8
Aircraft	698.7	11.3
Glass	20.0	0.3
Burglary/theft	109.0	1.8
Boiler/machinery	576.0	9.3
Total	$205,289.8	$3,325.6

[3]The percentage cap would be either 1, 1.5, or 2 percent. One state calculates capacity by a more complex formula; this formula yields a cap of about 2 percent.

[4]We excluded lines of insurance (such as ocean marine, surety, fidelity, accident and health, credit) that are not covered by most state guaranty funds.

[5]Although both premiums and potential guaranty fund assessments (capacity) are presented on a national basis in table 2.1, the model actually compares losses and capacity within each state.

COMPARING LOSSES AND CAPACITY

We compared average yearly losses by state for each of the three composite companies with each state's estimated capacity. In making this calculation the premium estimate for each composite failed company was subtracted from the premium base for the guaranty fund assessments. By dividing estimated losses incurred by the estimated capacity of the state fund system, we calculated the number of years required in each state to pay 1 year's losses for the composite failed company.[6] These results are shown in table 2.2.

Table 2.2: Length of Time Required to Pay off 1 Year's Obligations

	Number of states[a] requiring			
	Less than one year	Between 1-2 years	2 years or more	Total
If company A failed ($4.2 billion in losses)	18	27	6	51
If company B failed ($3.9 billion)	16	29	6	51
If company AB failed ($4.0 billion)	13	34	4	51

[a]Includes District of Columbia.

We found that, generally, the guaranty fund system would not have the capacity to pay out 1 year's worth of claims on a failure of one of the largest property/casualty insurers within the same year. Table 2.2 shows that, assuming guaranty fund obligations were set at 100 percent of losses, many states would not be able to pay off their state's share of 1 year's losses within a year, and some could not do so within 2 years.

As can be seen from table 2.3, the system could just barely handle a single company failure if we set guaranty fund

[6]Since guaranty fund assessments operate on a calendar year basis, we are assuming that our hypothetical failure occurs at the beginning of a calendar year.

obligations at 75 percent of losses. Given the possibility that amounts to be paid by guaranty funds may be less (or more) than the estimated losses, we tested various estimates of guaranty fund obligations. We initially made our calculations using 100 percent of the losses of our composite companies as a proxy for guaranty fund obligations; we then also generated figures assuming that obligations varied between 50 and 150 percent of annual losses.

Table 2.3: Years to Pay Off at Different Loss Levels

	50%	75%	100%	125%	150%
Company A failure	0.67	1.00	1.34	1.67	2.01
Company B failure	0.64	0.96	1.28	1.60	1.92
Company AB failure	0.65	0.98	1.31	1.64	1.96

These data only cover projected guaranty fund claims for a single year. Claims that could not be paid in 1 year might have to be deferred until the following year. In that following year, however, more claims reported against the failed insurers would be added to the queue, and other insurers may fail as well. Depending on a fund's capacity, claim deferral and delayed payment could persist for several years. Finally, the model also assumes that there are no failed companies "in the pipeline," that is, that no other company failures are already being handled by the guaranty funds. As previously stated, our model simulates what could happen if a large insurer failed. We are not predicting whether one of the top U.S. insurers will fail.

CONCLUSION

Given the results of our model, we question whether the state guaranty fund system, as it is presently set up, is capable of dealing with the failure of a company the size of the largest property/casualty insurers or with the simultaneous failure of several medium-to-large insurers. In the event of such a failure, or combination of failures, the system could not sustain the burden. At best, some policyholders and claimants would have to wait, perhaps for some time, before receiving compensation for legitimate claims.

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